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**SUPREME COURT OF THE UNITED STATES**

**OCTOBER TERM, 1942**

320 n S # 37  
**No. 129** MOR-NIK

**MORRIS INVESTMENT CORPORATION,**  
*Petitioner,*

*vs.*

**COMMISSIONER OF INTERNAL REVENUE.**

\_\_\_\_\_  
**PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS,  
FOR THE THIRD CIRCUIT, AND BRIEF IN SUP-  
PORT THEREOF.**

\_\_\_\_\_  
**EDWARD L. BLACKMAN,**  
*Counsel for Petitioner.*



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No. 129

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MORRIS INVESTMENT CORPORATION,  
*Petitioner,*  
*against*

COMMISSIONER OF INTERNAL REVENUE.

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**PETITION FOR WRIT OF CERTIORARI.**

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*To the Honorable the Chief Justice of the United States and  
the Associate Justices of the Supreme Court of the  
United States:*

The petition of Morris Investment Corporation herein respectfully shows to this Honorable Court:

A.

**Summary Statement of the Matter Involved.**

This proceeding was a petition by the taxpayer, Morris Investment Corporation, addressed to the United States Circuit Court of Appeals for the Third Circuit, for a review of the decision of the United States Board of Tax Appeals (now the United States Tax Court) ordering and

deciding that there were deficiencies in Income Tax and Personal Holding Company Surtax of the petitioner for the year 1937 in the respective amount of \$15,738.74 and \$56,205.96.

The matter was presented to the Board of Tax Appeals and although the parties were unable to agree upon a stipulation of facts prior to the trial, the trial developed no issue of fact.

Two principal questions were involved:

1. The petitioner claimed that it was not liable for any Undistributed Profits Tax or any Personal Holding Company Surtax for the year 1937 for the reason that while it had statutory income for the year 1937 it had no income which it could lawfully distribute to its stockholders and was unable to declare any dividend which would be taxed to its stockholders; and

2. For the further reason that neither of said so-called taxes was really a tax at all, but each constituted a penalty applied for the coercion and destruction of certain corporations.

The petitioner made other and further claims to the effect that the said taxes applied to the petitioner in the case at bar are unconstitutional and void.

Petitioner based all of the above claims on the fact that it was a so-called "deficit corporation" and could make neither a lawful distribution to its stockholders during the taxable year nor any distribution lawful or unlawful which would be taxable to its stockholders, and for which it could obtain a dividends paid credit under the 1936 and 1937 Acts.

The United States Board of Tax Appeals, as above stated, found on all points for the respondent and ordered and decided that the said deficiencies existed.

The petitioner petitioned the United States Circuit Court

of Appeals, Third Circuit, for a review of the decision of the United States Board of Tax Appeals.

After the briefs had been filed by the attorneys for the respective parties, but prior to the argument of the case before the Circuit Court of Appeals, Third Circuit, which took place on the third day of November, 1942, the Revenue Act of 1942 became effective (October 21, 1942).

The new Revenue Act amended the Internal Revenue Code in a number of respects, including an amendment of the Undistributed Profits Tax provision which had already been repealed. (Section 501, Revenue Act of 1942 (56 Stat. C. 619), amending Section 14 (a) (2), Section 26 (c) and Section 26 of the Revenue Act of 1936 (49 Stat. C. 690) ).

Upon the oral argument before the United States Circuit Court of Appeals, the government conceded that the Amendment to the Undistributed Profits Surtax might have a bearing on petitioner's liability for that tax, and both parties thereupon agreed that the cause be remanded to the Board for consideration of the effect of that section upon petitioner's liability for the Undistributed Profits Surtax (R. 36) (134 F (2) 774). That point is therefore not involved in this petition.

Petitioner, however, contended that the Revenue Act of 1942 completely sustained petitioner's contention that not only the Undistributed Profits Tax but the Personal Holding Company Surtax were unconstitutional and void in so far as applied to "deficit corporations", which could not avoid the imposition of the heavy taxes provided in those sections by distributions to their stockholders because such distributions would not be taxable to the stockholders and therefore would not be considered as deductions from undistributed income (R. 36), (134 F. (2) 774).

The United States Circuit Court of Appeals for the Third Circuit overruled petitioner's contention and confirmed the

decision of the Board of Tax Appeals in so far as it determined the petitioner's liability for the Personal Holding Company Surtax (R. 38).

However, it remanded the cause with respect to the Undistributed Profits Surtax to the Tax Court of the United States, with directions to reconsider petitioner's liability thereunder in the light of Section 501 of the Revenue Act of 1942 (R. 38).

Therefore the sole question presented by the petitioner herein, is as to petitioner's liability for Personal Holding Company Surtax under the Revenue Act of 1936 (49 Stat., p. 1648), as amended, including the amendments of that Act by the Revenue Act of 1942.

The decision of the United States Board of Tax Appeals was entered in the Office of the Clerk of the said Board on the 5th day of January, 1942, and the opinion and decision of the Circuit Court of Appeals, Third Circuit, affirming that decision, was handed down and filed on the 31st day of March, 1943 (R. 35).

The Order for Mandate of the United States Circuit Court of Appeals, Third Circuit, was issued on the 20th day of April, 1943 (R. 38).

## B.

### **Specification of Errors.**

The Circuit Court of Appeals for the Third Circuit erred:

1. In affirming the order of the Board of Tax Appeals in so far as it determined the petitioner's liability for the Personal Holding Company Surtax, and in determining that there was a deficiency in Personal Holding Company Surtax of the petitioner to \$56,205.96 for the year 1937.

2. In failing to reverse the order of the Board of Tax Appeals and direct the respondents to redetermine the said



deficiency in Personal Holding Company Surtax for the year 1937 and find that no deficiency existed.

3. In failing to find and hold that petitioner was, during the year 1937, a "deficit corporation" within the meaning of Section 501 of the Revenue Act of 1942, (56 Stat. C, 619) amending Section 26 (c) of the Revenue Act of 1936 (49 Stat. C, 690).

4. In failing to find and hold that petitioner had a deficit in accumulated earnings and profits as of the close of the year 1936 and a greater deficit at the close of the year 1937, and that petitioner was prohibited by a provision of law of the State of Delaware, under the laws of which State petitioner was incorporated, from paying dividends during the year 1937, and that such provision of law of the State of Delaware was in effect during the entire year 1937 and prior to the first of May, 1936.

5. In failing to find and hold that the provisions of Section 501 (a) (3) of the Revenue Act of 1942 (56 Stat. C, 619) amending Section 26 of the Revenue Act of 1936 (49 Stat. C, 690), relating to the credits of corporations, by adding a new sub-paragraph (f), entitled "deficit credit", applied to every case provided for in the Internal Revenue Code where "adjusted net income" and "undistributed adjusted net income" were referred to, and that such provision is not restricted to the case of the Undistributed Profits Tax only.

6. In failing to find and hold that under Sections 26 (c) and 26 (f) of the Revenue Act of 1936 (49 Stat. C, 690), as amended by the Revenue Act of 1942 (56 Stat. C, 619), the petitioner, being a "deficit corporation", in computing its Personal Holding Company Surtax, was entitled to a deficit credit equal to the amount by which its adjusted net income exceeded its earnings and profits accumulated after

February 28, 1913, and up to the beginning of the taxable year 1937, and the earnings and profits of the taxable year 1937, and in failing to find that such credit would wipe out completely petitioner's adjusted net income for the year 1937.

7. In failing to hold and find that the Section 351 of the Revenue Act of 1936 (49 Stat. C, 690), as amended by Sections 353 to 360 of the Revenue Act of 1937 (which sections provide for the taxation of Personal Holding Corporations) were unconstitutional and void as applied to this petitioner, a deficit corporation (U. S. Const., Amdts 5 and 14).

### C.

#### **Reasons Relied Upon for the Allowance of the Writ.**

The questions relied upon are Federal questions arising under the Revenue Acts of 1936, 1937 and 1942 and are as follows:

(a) whether the Personal Holding Company Surtax, Title I-A of the Revenue Act of 1936, as amended by the Revenue Act of 1937 (Chapter 815, 50 Stat., 813), was retroactively amended by the Revenue Act of 1942, Section 501 (a) (56 Stat. C, 619), in such manner that petitioner is entitled to the "deficit credit" provided by said Act which credit would reduce to nothing its undistributed adjusted net income for 1937.

(b) whether the said Personal Holding Company Surtax, as imposed by the Revenue Act of 1936 (49 Stat. C, 690), as amended by the Revenue Act of 1937 (50 Stat. C, 815), was not unconstitutional and void because it amounted to an attempt in the guise of a tax to destroy so-called Personal Holding Companies, and furthermore, because, piled on top of other taxes

against so-called Personal Holding Companies, it amounted to arbitrary confiscation and not lawful taxation.

It is submitted that the question of the effect of the Revenue Act of 1942 on the taxable income of Personal Holding Companies for the taxable year 1937, and subsequent taxable years up to and including 1941, is obviously a question which will arise in the case of a large number of Personal Holding Companies, and that its proper determination is a matter affecting many persons and large amounts of income, and is a matter of grave public interest and importance.

This question has not previously been decided by this Court nor, the petitioner believes, by any Court other than in this case by the United States Circuit Court of Appeals for the Third Circuit, a review of whose decision this petition seeks.

Since Section 186 (h) and 501 (c) of the Revenue Act of 1942 (56 Stat. C, 619) provide for refunds or credits to the extent of any overpayments of Undistributed Profits Tax and of Personal Holding Company Surtax for any taxable years resulting from the retroactive application of those two sections of the Revenue Act of 1942, it is obvious that the interpretations placed upon these sections is extremely important and is a matter of vital interest in terms of dollars and cents to a great many corporations and persons. Those sections constitute an attempt by Congress to remedy a situation which resulted from prior revenue acts and which was obviously a grave injustice, to wit, the penalizing of the stockholders of corporations because of the fact that the said corporations could not legally distribute what constituted statutory but not real income and penalized those corporations whose dividends were not taxable to its stockholders.

We therefore respectfully submit that the questions herein involved are matters of great public importance and should be settled by this Court at the earliest possible moment in order to avoid and render unnecessary a multiplicity of suits for refunds of overpayments of taxes paid by Personal Holding Companies during the years affected by the amendment (1937-1941).

WHEREFORE, your petitioner respectfully prays that a Writ of Certiorari be issued to review the judgment of the Circuit Court of Appeals for the Third Circuit, ordering and deciding that there was a deficiency in Personal Holding Company Surtax of said petitioner for the year 1937 in the amount of \$56,205.96; that said judgment be reversed and that your petitioner may have such other and further relief in the premises as may be just and proper.

Dated: New York, New York, June 28, 1943.

MORRIS INVESTMENT CORPORATION,  
*Petitioner,*

By EDWARD L. BLACKMAN,  
*Counsel for Petitioner,*  
120 Broadway,  
New York, New York.

STATE OF NEW YORK,  
*County of New York, ss:*

EDWARD L. BLACKMAN, being duly sworn, says:

That he is the counsel for Morris Investment Corporation, the petitioner, that he prepared the foregoing petition, and that the allegations thereof are true as he thoroughly believes.

EDWARD L. BLACKMAN.

Sworn to and subscribed before me this 28th day of June, 1943.

FLORENCE E. AVERY,  
*Notary Public, Nassau County.*





SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

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No. 129

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MORRIS INVESTMENT CORPORATION,  
*Petitioner,*  
*against*

COMMISSIONER OF INTERNAL REVENUE.

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**BRIEF IN SUPPORT OF PETITION FOR WRIT OF  
CERTIORARI.**

I.

**The Opinions of the Courts Below.**

The memorandum opinion of the United States Board of Tax Appeals (R. 29-34), promulgated January 5, 1942, was not reported (46 B. T. A. 1276).

The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 35), is reported in 134 F. (2d) 774.

II.

**Jurisdiction.**

1. The statutory provision believed by petitioner to sustain the jurisdiction of this Court is Section 240 of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938. 24 U. S. C. A. Sec. 347.

2. The statutes involved are the Revenue Act of 1936, United States Statutes At Large, 1935-1936, Vol. 49, Part I, c. 690, p. 1648; Revenue Act of 1937, United States Statutes At Large, 1937, Vol. 50, Chap. 815; and the Revenue Act of 1942, United States Statutes At Large, Vol. 56, Chap. 619.

The pertinent provisions of these statutes are set out in the Appendix, *infra*, pages 30 to 33.

The sections of the Act quoted in the Appendix are the applicable sections defining the income subject to the Personal Holding Company Surtax and providing for the credits in arriving at "undistributed adjusted net income" of Personal Holding Companies, and giving the amendments contained in the 1942 Act retroactive effect, and providing for the refund of overpayments of tax.

3. The Order for Mandate of the Circuit Court of Appeals, Third Circuit, was issued on the 20th day of April, 1943. This petition was docketed on the 30th day of June, 1943.

4. One of the controlling questions relied upon herein was one of the controlling questions raised upon the record in the United States Board of Tax Appeals. That question was whether or not the deficiency assessed against the petitioner for Personal Holding Company Surtax violated the Federal Constitution Amendments 5 and 14. Such question, and the question of the effect of the Revenue Act of 1942 upon the deficiency assessed against this petitioner for the year 1937 (this Act was not passed until after decision of the Board of Tax Appeals) were the controlling questions raised upon the appeal to the United States Circuit Court of Appeals, Third Circuit. In other words, was not the Personal Holding Company surtax as applied to this deficit corporation (petitioner), unconstitutional, and in any event, was not this deficiency assessment retroactively wiped out by the provisions of the Revenue Act of 1942?



The first of these questions was raised in briefs and arguments before the United States Board of Tax Appeals and its judgment could not have been rendered without deciding the question of the constitutionality of the imposition upon this taxpayer of the Personal Holding Company Surtax as imposed by the Revenue Act of 1936, as amended by the Revenue Act of 1937. The judgment of the United States Circuit Court of Appeals for the Third Circuit could not have been rendered without deciding all of the above questions all of which were raised in the briefs and argument before that court.

### III

#### **Statement of the Case.**

The facts in this case are few (R. 12-28) and although not stipulated, are undisputed. As found by the Board of Tax Appeals, they are as follows:

The alleged deficiency of surtax on Personal Holding Company amounts to \$56,205.96. It is based upon a computation by the Commissioner of Internal Revenue of "undistributed adjusted net income of \$75,207.94", upon the first \$2,000 of which there is assessed a surtax of 65%, equaling \$1300, and upon the balance a surtax of 75%, equaling \$54,905.96, totaling \$56,205.96 (R. 15).

Petitioner claims that it was not liable for any Personal Holding Company Surtax for the year 1937 for the reason that it had in that year no income which could be lawfully distributed to its stockholders and for the further reason that the said Personal Holding Company Surtax is not really a tax at all, but constitutes a penalty applied for the coercion and destruction of certain corporations, especially if "imposed against deficit corporations", and for the further reason that the Revenue Act of 1942 (Section 501 (a)) grants an additional credit to all Personal Holding Com-

panies which are "deficit corporations" by limiting or bringing down the adjusted net income of such Personal Holding Companies to a point where it does not exceed the earnings and profits accumulated between February 28, 1913 and the beginning of the tax year, plus the earnings and profits of the tax year.

The facts upon which petitioner bases its claim that the said deficiency assessment is improper, are as follows:

Petitioner is a Delaware corporation (R. 22).

The Certificate of Incorporation of petitioner was duly executed by the incorporators thereof on the 29th day of December, 1928, and was received and filed in the office of the Secretary of State of the State of Delaware on December 31, 1928 and recorded in the Recorder's Office in Wilmington, in New Castle County, Delaware, on the 31st day of December, 1928 (R. 24-29).

Petitioner's By-laws contained throughout the year 1937 the following provisions in Paragraph 39 thereof:

"Dividends upon the capital stock of the corporation, subject to the provisions of the Certificate of Incorporation, if any, may be declared by the Board of Directors at any regular or special meeting, pursuant to law" (R. 22).

The General Corporation Laws of the State of Delaware did, throughout the year 1937 (Rev. Code of Delaware, 1935, Chap. 65), contain the following provisions:

"Section 34. *Dividends: Reserves:* The directors of every corporation created under this chapter, subject to any restrictions contained in its certificate of incorporation, shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14, 26, 27 and 28 of this chapter; or (b) in case there shall be no such excess, out of its net profits for the

fiscal year then current and/or the preceding fiscal year. \* \* \* ,”

“Section 35. No corporation created under the provisions of this chapter, nor the directors thereof, shall pay dividends upon any shares of the corporation except in accordance with the provisions of this chapter. \* \* \* ,”

“Section 83. This chapter may be amended or repealed at the pleasure of the Legislature, but such amendment or repeal shall not take away or impair any remedy against any corporation under this chapter, or its officers, for any liability which shall have been previously incurred; this chapter and all amendments thereof shall be a part of the charter of every such corporation except so far as the same are inapplicable and inappropriate to the objects of such corporation.”

Petitioner was organized in 1928 to engage in the investment business, and since that date has so engaged (R. 28, 19-21).

During the years 1934 to 1937, petitioner made net losses each year as follows:

In 1934 a net loss of \$5,730.22.

In 1935 a net loss of \$3,958.24.

In 1936 a net loss of \$5,601.99.

In 1937 a net loss of \$39,952.35 (R. 20).

The losses made subsequent to 1934 reduced the surplus shown on the books to \$30,788.62 at the close of the calendar year 1936, and the 1937 loss wiped out that surplus entirely and left a deficit of \$9,163.73 (R. 20, 21).

However, the undisputed testimony shows that the books overstated by some \$88,000 the true net position of the company. Thus, in 1933 the company's books showed a net profit of \$41,287.20. That was not paid out in dividends, but the stockholders each returned his pro rata share in his personal income tax, and this taxpayer in its return showed

the amount each of the stockholders had returned and had paid a tax or surtax on (R. 21, 22). This was pursuant to Section 104(d) of the Revenue Act of 1932 (47 Stat. Part I. C. 209).

Furthermore, the books of the company, which showed a surplus as of January 1, 1937 of \$30,788.62, failed to record either the above transaction of the stockholders, which was in effect a payment to them of earnings and the lending of it back to the company (R. 21), but also failed to show a loss of \$46,000 (R. 21).

To summarize, the company's entire operations from incorporation to the end of the tax year 1937 showed a loss of \$9,163.73 and a loss of \$39,952.35 for the tax year alone, according to its books. However, those books failed to show the two deductions from surplus above referred to, and therefore, the accounts properly stated should have shown a deficit of approximately \$50,000 at the beginning of the tax year 1937 instead of a surplus of \$30,788.62, which, as above stated, was wiped out by the loss of \$39,952.33 incurred in the tax year (R. 20-22).

While the taxpayer had a substantial statutory income for the tax year 1937, it suffered an actual loss for that year, as above stated, through the sale of capital assets (R. 31).

The Commissioner of Internal Revenue ruled that the failure to pay out the statutory gain made the company liable for \$73,748.67 upon a taxable net income of \$81,414.84 (R. 14, 15), under the undistributed profits tax and the Personal Holding Company Surtax Provisions of the Revenue Act of 1936.

Petitioner appealed to the United States Board of Tax Appeals, which upheld the Commissioner. From that decision petitioner appealed to the United States Circuit Court of Appeals, Third Circuit.

As above stated, a few days prior to the argument, the Revenue Act of 1942 was passed, which amended retroactively the Revenue Act of 1936, and as claimed by petitioner, relieved it from liability under the Undistributed Profits Tax provision and the Personal Holding Company Surtax provision of the Revenue Act of 1936.

The United States Circuit Court of Appeals, as stated above, remanded the cause to the United States Tax Court for further findings as to the effect of the Revenue Act of 1942 on petitioner's liability under the Undistributed Profits Tax, but affirmed the United States Board of Tax Appeals' decision assessing against petitioner for the year 1937 a deficiency for Personal Holding Company Surtax in the amount above stated.

For a review of this decision petitioner submits this petition.

#### IV.

##### **Assignment of Errors.**

A statement of the assignment of errors relied upon will be found in the petition (pp. 4 to 6, *supra*).

#### V.

##### **Argument.**

The petitioner's argument is summarized as follows:

##### POINT A.

The decision of the court below is in conflict with Section 351 and Section 26 of the Revenue Act of 1936 as amended by Section 501 (a) (2) and (3) of the Revenue Act of 1942 and erroneously imputes to the Congress an intention to remedy a recognized inequity and injustice as to corporations generally but to continue that same injustice in the case of personal holding companies.

## POINT B.

Section 351 of the Revenue Act of 1936, as amended by Secs. 353 to 360, inclusive, of the Revenue Act of 1937 (which secs. provide for the taxation of Personal holding corporations) when piled on top of the ordinary corporation income taxes and surtaxes (Secs. 13 and 14 of Revenue Act of 1937) were so excessive as to confiscate petitioner's property, and were unconstitutional and void as applied to this petitioner, a deficit corporation.

## POINT C.

The decision below upon each of the above points "A" and "B" presents a substantial Federal question which has not been, but should be, decided by this Court.

## POINT D.

The question sought to be reviewed by this Court is of great importance to a very considerable class of income taxpayers and in order to avoid a multiplicity of suits raising the same identical point as hereinabove, should be decided by this Court.

## POINT A.

The decision of the court below is in conflict with Section 351 and Section 26 of the Revenue Act of 1936 as amended by Section 501 (a) (2) and (3) of the Revenue Act of 1942 and imputes to the Congress an intention to remedy a recognized inequity and injustice in the case of corporations generally but to continue that same injustice in the case of personal holding companies.

*The Situation in Which Holding Companies Are Left Under  
The Revenue Act of 1942.*

In 1936 and 1937 the status of Personal Holding Companies was substantially changed.

*First*, there was imposed upon all corporations, including Personal Holding Companies, the surtax on undistributed profits, which was enacted in 1936 (49 Stat. c. 690, Sec. 14), and repealed in 1938 (omitted from Rev. Act. 1938, 52 Stat. c. 289).

*Second*, the statutory income of Personal Holding Companies was changed by the withdrawal of the right to deduct losses in computing statutory net income and the Personal Holding Company Law imposed heavy taxes in addition to the Undistributed Profits Taxes on those Personal Holding Companies which had failed to make distribution of their statutory profits. Sec. 351 (b) (3) of the Revenue Act of 1936 (49 Stat. c. 690) as amended by Sec. 356 (a) of the Revenue Act of 1937 (50 Stat. c. 815).

*Third*. Regulations 94 (Art. 27 (h) (1)) of the Treasury Department, which is in strict accord with the Revenue Act, shows that a so-called deficit corporation, and certainly one which not only had a deficit at the beginning of the tax year, but also suffered a deficit during that year (R. 20, 21), had no means by which it could escape the heavy imposition of the Undistributed Profits Tax. This was so, because the credit for distribution to stockholders was limited to those distributions which would be taxable in the hands of the stockholders (Sec. 27 (h) of the Revenue Act of 1936). See also Art. 27 (h) 1 of Regulations 94, which is as follows:

*“Non-Taxable Distributions.*—No dividends paid credit shall be allowed with respect to any part of the

distribution by a corporation to its shareholders, which is—(a) not out of earnings or profits of the taxable year, or out of earnings or profits of the corporation accumulated subsequent to February 28, 1913 (See Section 115), or in case of distributions in liquidation not properly chargeable to earnings or profits of the corporation accumulated after February 28, 1913, under Article 27 (f)-1 \* \* \*. The effect of Subsections (g) and (h) of Section 27 is that no dividends paid credit is allowed with respect to any distribution unless each of the shareholders of that class who are subject to taxation under Title I for the period in which the distribution is made, receives a taxable dividend as a result of the distribution.”

Obviously, if the taxpayer was a deficit corporation, and if the only distributions it could possibly make to its stockholders, whether legal or illegal, would come from capital, then the distribution would not qualify as a deduction under the provisions of the law or the regulations of the Treasury Department, and the luckless corporation would be penalized regardless of what it did with its statutory income.

Doubtless it was this most unfair situation which prompted Congress to take the extraordinary course of amending the Undistributed Profits Tax Law four years after it had been repealed.

It is the contention of the Commissioner of Internal Revenue that the benefit of this remedial Act was not extended to Personal Holding Companies, and that therefore all Deficit Personal Holding Companies are left in the same situation in which they were in 1936 and 1937.

In taking that position, the Commissioner of Internal Revenue completely ignores the fact that Section 501 (a) (3) of the Revenue Act of 1942 amended Section 26 of the Revenue Act of 1936, which applies to every corporation, including Personal Holding Companies.



By this section of the Act of 1942, there was added to Section 26 of the Revenue Act of 1936 a further subdivision (f) entitled "Deficit Credit", which limits or brings down the undistributed adjusted net income of a corporation to an amount not in excess of the accumulated earnings and profits subsequent to February 28, 1913, plus the earnings and profits of the taxable year.

As above stated, it was admitted by the Commissioner and the Circuit Court of Appeals held that said Section 501 (a) (3) applied to Personal Holding Corporations and reduced their adjusted net income.

**The amendments to the Revenue Act of 1942 give the same relief to deficit corporations against the harsh provisions of the personal holding company surtaxes as they do against the provisions of the undistributed profits surtax.**

As already shown, the Circuit Court recognized that the 1942 Act did relieve deficit Personal Holding Corporations from Undistributed Profit Taxes.

For the convenience of the Court, in the following paragraphs petitioner cites in detail the portions of the Revenue Acts above referred to and their application to the present situation:

The surtax on Personal Holding Companies is contained in Chapter II, Subchapter (a) of the Internal Revenue Code. The Sections covering this surtax are 500 to 506.

The Revenue Act of 1936 also provided for a surtax on Personal Holding Companies found in Title I-A, Section 351. (49 Stat. c. 690).

That Act was amended in 1937 to deprive Personal Holding Corporations of the right they previously had of taking into account their capital losses in computing their net income (Revenue Act 1937 Section 356 (a), (50 Stat. C. 815), compare Section 351 (b) (3) of Revenue Act 1936).

After that the statutory net income of Personal Holding Corporations was the same as for other corporations.

The Revenue Act of 1936 (Section 14 (a) (2) also contains a definition of "Undistributed Adjusted Net Income", which meant statutory net income minus certain stated items, the last of which was in Subdivision (c) of Subdivision 2:

"The amount of the dividends paid credit provided in Section 27 computed without the benefit of Subsection (b) thereof (relating to the dividend carry-over)."

Referring now to Section 27 of the Revenue Act of 1936, we find that it provides for the corporation credit for dividends paid and said Section 27 contains eight subdivisions, the last of which is Subdivision (h)—"Non-taxable Distributions." This Subdivision provides:

"If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part."

In other words, under the Act of 1936, which, in so far as this particular question is concerned, was in effect during the year 1937, a corporation in order to obtain credit for dividends paid during the year in computing income subject to the Personal Holding Company surtax, must show that those dividends were taxable dividends in the hands of the stockholders.

In the case of the Morris Investment Corporation, had it attempted to avoid the Personal Holding Company Surtax by distributing to its stockholders the entire amount which was taxed as undistributed profits, such distributions would not have been taxable in the hands of the stockholders and

therefore they would not have been deductible from the adjusted net income in determining undistributed adjusted net income. Such a distribution not only would have been contrary to the law of the State of incorporation, (R. 21; see p. 12, *supra*) but would have been a distribution of capital and not taxable in the hands of the shareholders.

It was this compulsion upon the taxpayer to do something which was illegal and for which he could receive no credit if he did do it that caused Congress to amend retroactively the Undistributed Profits Surtax provision, even though that law had been repealed for over four years.

Section 26 (c) of the Act of 1936, has for its Sub-heading "Contracts Restricting Payment of Dividends", and Subdivision 1 of that Subsection (c) has the heading "Prohibition on Payment of Dividends".

The new Revenue Act of 1942 (Section 501 (a) (2) (56 Stat. c. 619) amends Section 26 (c) by changing the heading to read "Restrictions on Payment of Dividends" and by adding a third sub-paragraph 3, which reads:

"Deficit Corporations:—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a Public Regulatory Body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936."

Section 26 of the Revenue Act of 1936 is further amended by the Revenue Act of 1942 (Section 501 (a) (3)) by the addition of several Sub-paragraphs which are not found in the old 1936 Act. One of these additions is Subdivision (f) entitled "Deficit Credit" and reads as follows:

"The amount by which the adjusted net income exceeds the sum of (1) The earnings and profits accumulated after February 28, 1913, as of the beginning of

the taxable year; and (2) The earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year). For the purposes of this Subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under Section 14, 102, 103 or 351 for such taxable year; and earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under Section 14, 102, 103 or 351 for any previous taxable year only by the amount of such tax, as computed under the amendment made by Section 501 of the Revenue Act of 1942."

Thus the addition of Subdivision (f) to Section 26 of the Revenue Act of 1936 adds an entirely new credit allowed corporations.

That new credit which applies to all corporations is apparently calculated to bring down the adjusted net income to a point where it will not exceed the earnings and profits accumulated after February 28, 1913, plus the earnings and profits of the taxable year. In this way, if the Company had no net income during the taxable year and had no accumulated earnings it could have no adjusted net income within the meaning of this provision. That is why the Subdivision is entitled "Deficit Credit".

These amendments are made retroactive to the date of the enactment of the Revenue Act of 1936 (Section 501, Subdivision (b) Revenue Act of 1942).

Subdivision (c) of the same section, same Act, provides for the refund or credit of overpayments under the former 1936 Act.

In the case of Personal Holding Companies, there are additional amendments to the Revenue Act of 1936, as

amended by the Revenue Act of 1937 (Sections 353 to 360, inclusive). These amendments are directed to provisions relating to deficiency dividends and consent dividends, and are designed even at this late date to furnish Personal Holding Corporations with means of escape from the unfair provisions of the Undistributed Profits Tax provisions. However, neither of these provisions are of any assistance or benefit to a corporation which is unable legally to declare a dividend and therefore unable to take advantage of the credits allowed corporations in computing Subchapter (a) income.

Congress by providing the additional deduction contained in the new Subdivision (f) added to Section 26 of the Revenue Act of 1936, has relieved all corporations, Personal Holding Companies, as well as others, from being penalized for failure to distribute deficits.

What difference can it make that one section is called a "Surtax on Undistributed Profit" and another section is called a "Surtax on Personal Holding Companies"? The Company is the same. The profits are the same. The restricting and prohibiting State Laws are the same, and the Revenue Act is the same. It would seem that the resulting injustice must likewise be the same.

To summarize the argument of this point:

Section 26 of the Revenue Act of 1936 provides that:

"In the case of a corporation, the following credits shall be allowed to the extent provided in the various sections imposing the tax."

The amendment of 1942 added a subsection (f) of Section 26, the provision above quoted, which allows a credit to the corporation of "the amount by which the adjusted net income exceeds the sum of the earnings and profits accumulated after February 28, 1913, as of the beginning

of the taxable year, and the earnings and profits of the taxable year (computed as of the close of the taxable year, without diminution by reason of any distributions made during the taxable year) \* \* \*.” (Sec. 501 (a) (3) of the Revenue Act of 1942.)

Subsection 5 of Section 501 makes that provision retroactive, as stated above.

Although the heading of Section 501 is “Additional Credits for Undistributed Profits Tax”, subsection (3) is an amendment of Section 26 of the Revenue Act of 1936 which applies to *all corporations*, including Personal Holding Companies, and the amendment is not specifically restricted to the case of the Undistributed Profits Tax.

It would therefore seem to be applicable in every case where the corporation came within its terms (R. 20-22).

Petitioner’s contention in this respect would seem to be fully supported by the fact that the Revenue Act of 1942 also provided retroactively for deficiency dividends by Personal Holding Companies for any year beginning after December 31, 1936, and before January 1, 1938, to wit, the year 1937.

Thus, under the Commissioner’s contention, if the Personal Holding Company had something which it could distribute to its stockholders that would be taxable to them, it could make such a distribution now and apply it retroactively against its tax liability for the year 1937, but if it had nothing which it could so distribute, it should not be entitled to the credit given in the amendment by the 1942 Revenue Act to Section 26 of the Revenue Act of 1936, but must be penalized.

The statement of this situation alone would seem to be a complete refutation of the contention of the Commissioner.

## POINT B.

**Sec. 351 of the Revenue Act of 1936, as amended by Secs. 353 to 360, inclusive, of the Revenue Act of 1937 (which secs. provide for the taxation of personal holding corporations) when piled on top of the ordinary corporation income taxes and surtaxes (Secs. 13 and 14 of the Revenue Act of 1937) were so excessive as to confiscate petitioner's property, and were unconstitutional and void as applied to this petitioner, a deficit corporation.**

As a result of all the taxes which are imposed upon a Personal Holding Corporation, if such corporation happened to be a deficit corporation it could well incur taxes which would amount to 120% of its statutory income, when it had been guilty of no violation of any provision of law and was entirely helpless to avoid such situation. The above situation results from the imposition of normal taxes, undistributed profits tax, Personal Holding Company surtax, and surtax under Sec. 102 of the Revenue Act of 1936. The tax actually imposed on this Company amounted to 85.5% of its statutory income (R. 14, 15). These excessive taxes and the impotence of a deficit corporation to avoid them, result as already shown, from the amendment of the Personal Holding Company law in 1937 which deprived Personal Holding Companies of the right to deduct capital losses which they had had prior to that year, coupled with the provision that the only distribution which would relieve any corporation, including a Personal Holding Corporation, from taxation upon its undistributed statutory income were distributions which would be taxable to the stockholders of the corporation.

It is obvious that the provisions with respect to undistributed profits were intended to force corporations to pay dividends to their stockholders so that such distributions in the hands of the stockholders might be taxed to them.

In order to avoid the evasion of this tax Congress provided that the only distributions that should be considered in determining the amount of undistributed profits were distributions that were taxable to the stockholders, but in so doing it completely overlooked the fact that deficit corporations such as the taxpayer which had a deficit in the tax year as well as a deficit over the entire period of its operation to the end of the tax year and a deficit at the beginning of the tax year, were powerless to avoid the imposition of these crushing taxes (R. 20-22).

The situation here presented is fundamentally different from that which was presented in *Helvering v. Northwest Steel Mills*, 311 U. S. 49 and *Crane Johnson v. Helvering*, 311 U. S. 54. In both of those cases the taxpayers had actual net income. Their claim to exemption from the undistributed profits tax was due to deficits which existed at the beginning of the tax year, which deficits the taxpayers claimed made it illegal, under the laws of the States of their incorporation, for them to pay out the profits of the tax year. This Court held that the fact that distributions to avoid the undistributed profits taxes were illegal did not relieve the companies from the taxes. As above shown Congress itself recognized the harshness of its provisions and by the 1942 Revenue Act has adopted provisions under which both of these companies may obtain refunds. The situation here presented however, is fundamentally different, this company having no surplus either at the beginning or end of the tax year, and having made a loss during the tax year could make no payment except from capital (R. 20-22).

Had such a distribution been made it would not have been taxable to the stockholders, and hence would not have entitled the corporation to any deduction from its statutory income in determining its undistributed adjusted net income.



To impose taxes in such circumstances is clearly unreasonable and unconstitutional, as a tax on petitioner's capital and not upon its income, and because the provisions of the Revenue Act of 1936 as amended do not constitute a tax but a penalty for failing to do that which Congress had no power to compel them to do, and for the further reason that the imposition of crushing taxes or penalties upon corporations which could not comply with the intent of Congress and distribute taxable dividends to their stockholders, and upon the further ground that the provisions of said acts which permit the deduction of taxable dividends paid by prosperous companies but which disallowed the deduction of non-taxable dividends (those paid by unsuccessful companies) is a gross and unreasonable discrimination in favor of prosperous companies and against unprosperous ones.

As above stated, the Revenue Act of 1942 not only relieved those companies, such as the Northwest Mills and Crane-Johnson, but also relieves companies which had no net surplus up to the end of the tax year.

If these provisions applied to all corporations, including Personal Holding Corporations, as petitioner argues in the preceding point, Congress has righted the wrong which it did. If, however, they do not so apply, as is argued by the Commissioner, and held by the Court below, then there is still a situation under which deficit personal holding corporations cannot avoid taxation at the rate of 75 per cent upon statutory earnings.

However, the constitutionality of the provisions of the Revenue Acts depends upon the situation which existed in 1937, at which time deficit personal holding companies might well incur taxes of 120 per cent upon statutory income, while powerless to avoid such taxes by distributions to its stockholders because such distributions would not be taxable to such stockholders.

## POINT C.

**The decision below presents a substantial Federal question which has not been, but should be, decided by this Court.**

It is hardly necessary to argue that the interpretation of the language of the Revenue Acts of 1936 and 1942 present a Federal question.

The Revenue Act of 1942 was passed only last October 21st, and there has not been, to petitioner's knowledge, any case before this Court involving the question being herein presented.

## POINT D.

**The question sought to be reviewed by this Court is of great importance to a very considerable class of income taxpayers and in order to avoid a multiplicity of suits raising the same identical point should be decided and settled by this Court.**

It is well-known that there are subject to the Revenue Laws of the United States a great many Holding Companies which fall within the definition of Personal Holding Companies contained in the Revenue Acts.

This Court may take judicial notice of the fact that a very large amount of property is invested in this type of corporation and that in the aggregate a great amount of income is affected by the laws taxing this type of corporation. Probably many of these Personal Holding Companies have, during one or more of the years between 1936 and the enactment of the Revenue Act of 1942, been "deficit corporations", and if petitioner's contention that the amendment to the Revenue Act of 1942 above discussed applies to Holding Companies, is correct, they should be relieved of deficiencies in Personal Holding Company Sur-

tax, either paid or assessed for some one or more of these earlier years.

It is respectfully submitted that an early decision by this Court on the question herein presented will furnish a guide to the Commissioner of Internal Revenue and to the aforesaid Personal Holding Companies, and will settle definitely a question which otherwise will likely result in a great deal of unnecessary litigation. Such clarification will be greatly in the public interest.

### **Conclusion.**

The petition for a Writ of Certiorari should be granted and the decision below reversed.

Dated: June 28, 1943.

EDWARD L. BLACKMAN,  
*Counsel for Petitioner,*  
*120 Broadway, New York, New York.*

## APPENDIX

*“The Revenue Act of 1936, Section 26—Credits of Corporations:*

“In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax”——

(Note)—There follow five subdivisions, (a) to (e), but no subdivision (f).

*“Section 27.—Corporation Credit for Dividends Paid:*

*Subdivision (h)—Nontaxable Distributions.*

“If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.”

*“Section 351.—Surtax on Personal Holding Companies—Subdivision (3).*

“The term ‘adjusted net income’ means the net income minus the sum of: \* \* \*

“(C) Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).”

*“The Revenue Act of 1937—Section 351, Surtax on Personal Holding Companies:*

“There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I) upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) 65 per centum of the amount thereof not in excess of \$2,000; plus

(2) 75 per centum of the amount thereof in excess of \$2,000.”

*“Section 355. Undistributed Adjusted Net Income.*

“For the purposes of this title the term ‘undistributed adjusted net income’ means the adjusted net income (as defined in section 356) minus

“(a) The amount of the dividends paid credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to the dividend carry-over); and

“(b) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.”

*“Section 356. Adjusted Net Income.*

“For the purposes of this title the term ‘adjusted net income’ means the net income with the following adjustments:

“(a) *Additional Deductions.*—There shall be allowed as deductions—

“(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 351 (either before or after its amendment by the Revenue Act of 1937), or a section of a prior income-tax law corresponding to either of such sections.

“(2) In lieu of the deduction allowed by section 23 (q), contributions or gifts made within the taxable year to or for the use of donees described in section 23 (q) for the purposes therein specified, to an amount which does not exceed 15 per centum of the taxpayer’s net income, computed without the benefit of this paragraph and section 23 (q), and without the deduction of the amount disallowed under subsection (b) of this section.

“(3) In the case of a corporation organized prior to January 1, 1936, to take over the assets and liabilities of the estate of a decedent, amounts paid in liquidation of any liability of the corporation based on the liability of the

decendent to make contributions or gifts to or for the use of donees described in section 23 (o) for the purposes therein specified, to the extent such liability of the decedent existed prior to January 1, 1934. No deduction shall be allowed under paragraph (2) of this subsection for a taxable year for which a deduction is allowed under this paragraph."

*"The Revenue Act of 1942—Section 501, Additional Credits for Undistributed Profits Tax.*

"(a) Amendments to the Revenue Act of 1936 \* \* \* .

"(3) Section 26 of the Revenue Act of 1936 (relating to credits of corporations) is amended by adding at the end thereof the following new subsections:

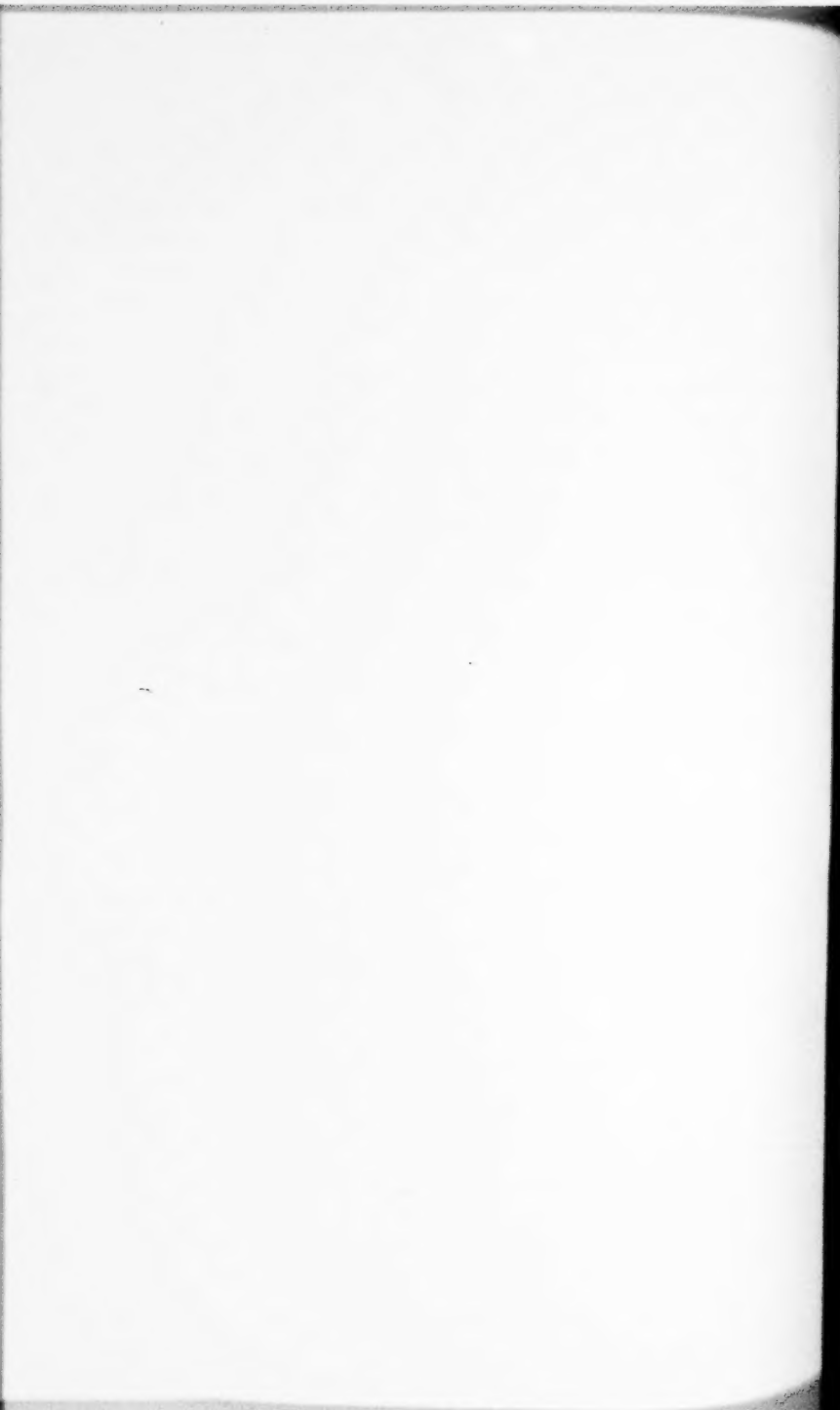
"(f) *Deficit Credit.*—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year). For the purposes of this subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under section 14, 102, 103, or 351 for such taxable year; and earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under section 14, 102, 103, or 351 for any previous taxable year only by the amount of such tax as computed under the amendments made by section 501 of the Revenue Act of 1942."

"(b) *Effective Date of Amendments.*—The amendments made by subsection (a) shall be effective as of the date of the enactment of the Revenue Act of 1936.

"(c) *Overpayments.*—If the refund or credit of any overpayment for any taxable year, to the extent resulting from the application of this section, is prevented on the date of the enactment of this Act or within one year from such date, then, notwithstanding any other provision of law or rule of law (other than this subsection and other

than section 3761 of the Internal Revenue Code or section 3229 of the Revised Statutes, or such section as amended by section 815 of the Revenue Act of 1938, relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an income tax erroneously collected under the Revenue Act of 1936, if claim therefor is filed within one year from the date of the enactment of this Act."

*Sec. 186—“(h) Overpayments and Deficiencies.*—If the refund or credit of any overpayment for any taxable year, to the extent resulting from the application of subsections (e) and (g) of this section is prevented on the date of the enactment of this Act or within one year from such date, then, notwithstanding any other provision of law or rule of law (other than this subsection and other than section 3761 of the Internal Revenue Code or section 3229 of the Revised Statutes, or such section as amended by section 815 of the Revenue Act of 1938, relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an income tax erroneously collected if claim therefor is filed within one year from the date of the enactment of this Act.”





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# In the Supreme Court of the United States

OCTOBER TERM, 1943

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No. 129

MORRIS INVESTMENT CORPORATION, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL  
REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE THIRD  
CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

### OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 29-33) is unreported. The opinion of the Circuit Court of Appeals (R. 35-38) is reported in 134 F. 2d 774.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 31, 1943 (R. 38-39). The petition for a writ of certiorari was filed on June 30, 1943. The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

#### QUESTIONS PRESENTED

1. Whether Section 501 of the Revenue Act of 1942 is applicable in computing the surtax on personal holding companies imposed by Section 351 of the Revenue Act of 1936, as amended by Section 1 of the Revenue Act of 1937.

2. Whether the personal holding company surtax, imposed by Section 351 of the Revenue Act of 1936, and as amended by Section 1 of the Revenue Act of 1937, is constitutional.

#### STATUTES INVOLVED

The pertinent statutes are set forth in the Appendix, *infra*, pp. 7-11.

#### STATEMENT

The material facts as found by the Board of Tax Appeals may be summarized as follows:

The petitioner is a personal holding company, organized in 1928 under the laws of Delaware to engage in the investment business (R. 30). In its income tax return for 1937 it reported a net income of \$81,414.84. Its return showed a net capital loss of \$114,022.38 over the \$2,000 allowable as a capital loss deduction (R. 31). The Commissioner made no adjustments with respect to the petitioner's reported net income, but did disallow credits against the surtax on undistributed

profits and the personal holding company surtax which had been claimed by the petitioner (R. 12-15, 32).

Before the Board of Tax Appeals the petitioner contended that the provisions of its charter and bylaws constituted contracts restricting the payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, and also that Section 14 of the Revenue Act of 1936, imposing a surtax on petitioner's undistributed profits, and Title IA of the 1936 Act, as amended by Section 1 of the Revenue Act of 1937, imposing a surtax on personal holding companies, were unconstitutional (R. 32). The Board of Tax Appeals sustained the Commissioner's determination (R. 33-34). The Circuit Court of Appeals affirmed the decision of the Board insofar as it determined petitioner's liability for the personal holding company surtax, and remanded the cause to The Tax Court with directions to reconsider petitioner's liability for the undistributed profits surtax, in the light of Section 501 of the Revenue Act of 1942 and of such evidence as might be relevant thereunder (R. 35-39).

#### ARGUMENT

1. Petitioner's contention that the amendments provided for in Sections 501 (a) (2) and (3) of the Revenue Act of 1942 (Appendix, *infra*, pp. 9-11) are applicable in computing the surtax on per-

sonal holding companies imposed by Section 351 of the Revenue Act of 1936, c. 690, 49 Stat. 1648, as amended, is without merit. The provisions of Section 501 of the Revenue Act of 1942, captioned "Additional Credits for Undistributed Profits Tax," are expressly limited to amending Sections 14 (a) (2) and 26 (c) of the Revenue Act of 1936. The latter two sections deal only with the imposition, under Title I of that Act, of the surtax on the undistributed profits of a corporation, and the credits allowed in computation thereof. Since the surtax on personal holding companies, imposed under Title IA by Section 351 of the Revenue Act of 1936, as amended, is a separate and distinct tax expressly designated as being in addition to the normal tax and surtax on undistributed profits imposed under Title I by Sections 13 and 14 of the Revenue Act of 1936, Section 501 of the Revenue Act of 1942 can have no application in computing the surtax on personal holding companies.

2. The same objections raised by the petitioner here as to the constitutionality of the personal holding company surtax have been considered and rejected by this Court in upholding the validity of the undistributed profits tax on corporations. *Helvering v. Northwest Steel Mills*, 311 U. S. 46; *Crane-Johnson Co. v. Helvering*, 311 U. S. 54. Both in the case of the undistributed profits surtax and the surtax on personal holding companies

Congress was focusing its attention upon the avoidance of surtax by the corporate stockholders that would otherwise result in the absence of such provisions. The reasons thus assigned by this Court in sustaining the validity of the undistributed profits tax have equal application to the personal holding company surtax.

Petitioner's contention (Br. 26) that the personal holding company surtax is a tax on its capital and that the situation here presented is fundamentally different from that presented in the *Northwest Steel Mills* and *Crane-Johnson* cases on the ground that petitioner herein sustained a loss during the taxable year is without merit. As in the case of the undistributed profits tax, the surtax on personal holding companies is imposed on profits earned during the taxable year, and there can be no dispute over the fact that during the taxable year petitioner suffered no statutory loss but rather, as disclosed by its own returns (R. 31), had a statutory net income of \$81,414.84 and an undistributed adjusted net income of \$75,207.94 (R. 13). Cf. *Helvering v. Northwest Steel Mills*, *supra*, p. 53.<sup>1</sup> It may

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<sup>1</sup> Petitioner's assertion that it suffered a "loss" during the taxable year disregards the statutory limitation upon the deduction of capital losses in computing net income. While petitioner may have sustained a loss in the accounting sense, it was not one recognized by the Revenue Act. The power of Congress to limit the deduction of capital losses can hardly be questioned. *New Colonial Co. v. Helvering*, 292 U. S. 435, 440; *White v. United States*, 305 U. S. 281, 292.

also be noted that contentions essentially identical to those made herein were advanced against the validity of the personal holding company surtax and rejected in *Foley Securities Corp. v. Commissioner*, 106 F. 2d 731 (C. C. A. 8th). See, also, *Simpson & Co. v. Helvering*, 128 F. 2d 742 (C. C. A. 2d), certiorari denied, 317 U. S. 677, certiorari granted June 7, 1943, on another issue No. 1, this Term; *Girard Inv. Co. v. Commissioner*, 122 F. 2d 843 (C. C. A. 3d), certiorari denied, 314 U. S. 699; *Noteman v. Welch*, 108 F. 2d 206 (C. C. A. 1st).

#### CONCLUSION

The decision of the court below is correct. It presents no conflict or question of general importance which would warrant further review by this Court. We respectfully submit that the petition should be denied.

Respectfully submitted.

CHARLES FAHY,  
*Solicitor General.*

SAMUEL O. CLARK, Jr.,  
*Assistant Attorney General.*

SEWALL KEY,

ARTHUR MANELLA,  
*Special Assistants to the Attorney General.*

JULY, 1943





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## APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

### SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term “adjusted net income” means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

\* \* \* \*

(2) The term “undistributed net income” means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c): [Here follow the rates] \* \* \*

Revenue Act of 1937, c. 815, 50 Stat. 813:

### SEC. 1. AMENDMENT OF 1936 ACT.

Title IA of the Revenue Act of 1936 is amended to read as follows:

## “TITLE IA—ADDITIONAL INCOME TAXES

### “SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

“There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

\* \* \* \* \*

### “SEC. 355. UNDISTRIBUTED ADJUSTED NET INCOME.

“For the purposes of this title the term ‘undistributed adjusted net income’ means the adjusted net income (as defined in section 356) minus—

“(a) The amount of the dividends paid credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to the dividend carry-over); and

“(b) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

### “SEC. 356. ADJUSTED NET INCOME.

“For the purposes of this title the term ‘adjusted net income’ means the net income with the following adjustments:

“(a) *Additional Deductions*.—There shall be allowed as deductions—

“(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 351 (either before or after its

amendment by the Revenue Act of 1937), or a section of a prior income-tax law corresponding to either of such sections.

“(2) In lieu of the deduction allowed by section 23 (q), contributions or gifts made within the taxable year to or for the use of donees described in section 23 (q) for the purposes therein specified, to an amount which does not exceed 15 per centum of the taxpayer’s net income, computed without the benefit of this paragraph and section 23 (q), and without the deduction of the amount disallowed under subsection (b) of this section.

“(3) In the case of a corporation organized prior to January 1, 1936, to take over the assets and liabilities of the estate of a decedent, amounts paid in liquidation of any liability of the corporation based on the liability of the decedent to make contributions or gifts to or for the use of donees described in section 23 (o) for the purposes therein specified, to the extent such liability of the decedent existed prior to January 1, 1934. No deduction shall be allowed under paragraph (2) of this subsection for a taxable year for which a deduction is allowed under this paragraph.

\* \* \* \* \*

Revenue Act of 1942, c. 619, 56 Stat. 954:

SEC. 501. ADDITIONAL CREDITS FOR UNDISTRIBUTED PROFITS TAX.

(a) *Amendments to the Revenue Act of 1936.*—(1) Section 14 (a) (2) of the Revenue Act of 1936 (relating to definition of undistributed net income) is amended to read as follows:

“(2) The term ‘undistributed net income’ means the adjusted net income minus the sum of (A) the dividend paid credit

provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g)."

(2) Section 26 (c) of the Revenue Act of 1936 (relating to credits of corporations) is amended by amending the heading to read as follows: "(c) *Restrictions on Payment of Dividends.*—"; and by amending paragraph (3) to read as follows:

"(3) *Deficit Corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

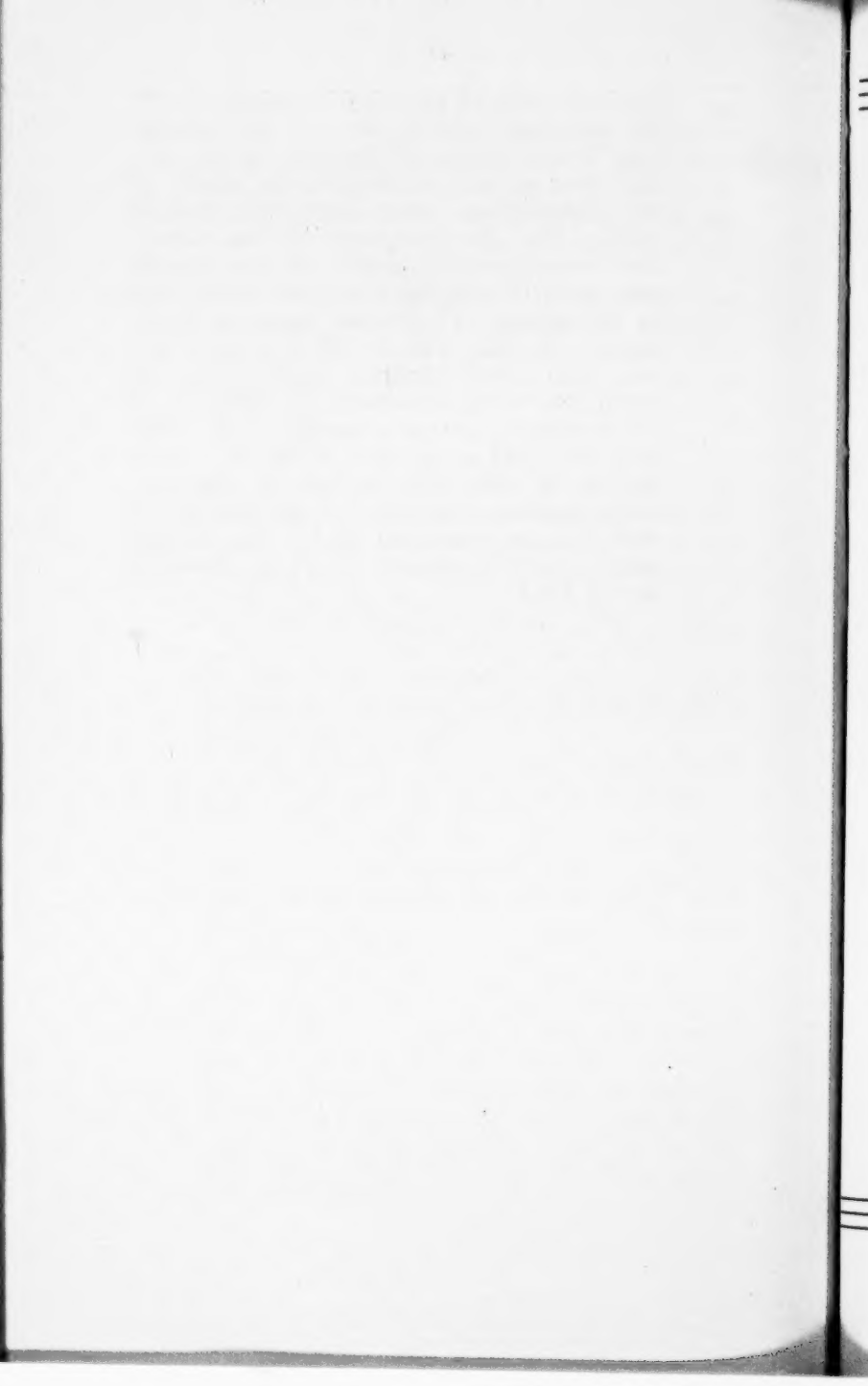
"(4) *Double Credit not Allowed.*—If more than one of the credits provided in the foregoing paragraphs (1), (2), and (3) apply, then the paragraph which allows the greatest credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

(3) Section 26 of the Revenue Act of 1936 (relating to credits of corporations) is amended by adding at the end thereof the following new subsections:

"(f) *Deficit Credit.*—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of

the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year). For the purposes of this subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under section 14, 102, 103, or 351 for such taxable year; and earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under section 14, 102, 103, or 351 for any previous taxable year only by the amount of such tax as computed under the amendments made by section 501 of the Revenue Act of 1942.

\* \* \* \* \*





(3)

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CHARLES ELMORE CROPLEY  
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# Supreme Court of the United States

October Term, 1942

No. 129

MORRIS INVESTMENT CORPORATION  
*Petitioner,*

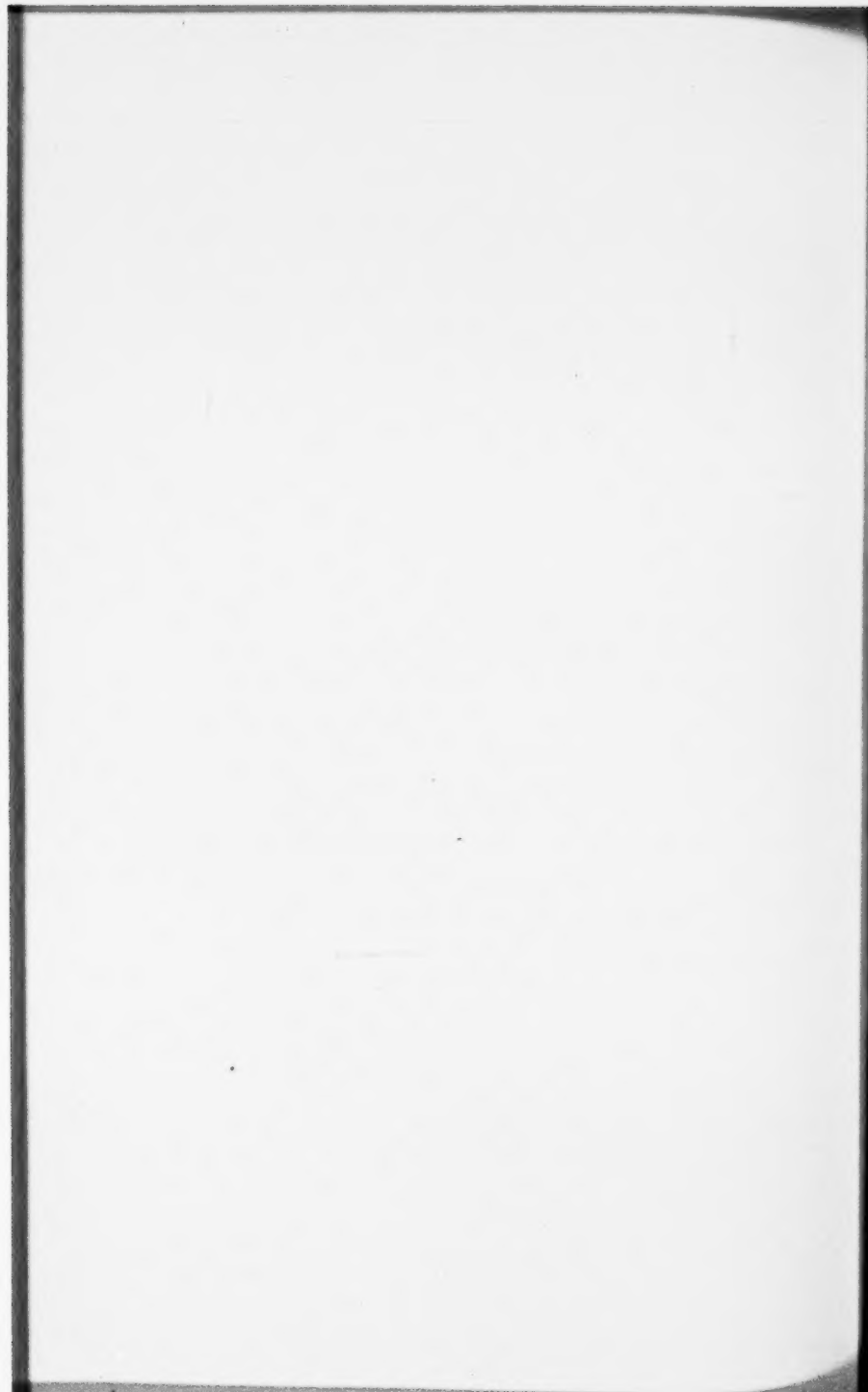
*vs.*

COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

## REPLY BRIEF OF PETITIONER.

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MORRIS INVESTMENT CORPORATION

*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

## REPLY BRIEF OF PETITIONER.

### I. Opinions of the Court Below.

The memorandum opinion of the United States Board of Tax Appeals (R. 29-34) promulgated July 25, 1942 was not reported (46 B. T. A. 1276). The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 35) is reported in 134 Federal Section 774.

### II. Jurisdiction.

The statutory provision believed by Petitioner to sustain the jurisdiction of this Court is Section 240 of the Judicial Code as amended by the act of February 13, 1925. 43 Stat. 938; 24 U. S. C. Section 347.

### **III. Questions Presented.**

These questions are set out in Petitioner's main Brief (p. 10). They are:

1. Whether or not the deficiency assessed against the Petitioner for Personal Holding Company Surtax violated the Federal Constitution, Amendments 5 and 14.

2. Whether the deficiency in Personal Holding Company Surtax assessed against Petitioner for the year 1937 is not rendered void by the provisions of the Revenue Act of 1942, particularly Section 501a thereof wherein it amends the provisions of Section 26c and Section 26 of the Revenue Act of 1936.

### **IV. Statutes Involved.**

The pertinent statutes are set forth in appendix to Petitioner's main Brief, pages 30 to 33, and in the appendix of Respondent's Brief, pages 9 to 11.

### **V. Statement.**

Statement of the case is set out in Petitioner's main Brief, pages 11 to 15.

### **VI. Argument.**

1. Respondent's Answer to Petitioner's Point A is no answer at all. It ignores the argument set out in Petitioner's main Brief, pages 17 to 24, and merely states that Sections 14(a)2 and 26(c) of the Revenue Act of 1936 deal only with the surtax on undistributed profits and not with the surtax on Personal Holding Companies. No reason for this statement is given by Respondent and it is

in fact incorrect. Section 26 of the Revenue Act of 1936 relates not only to corporations subject to the Undistributed Profits Surtax but to the credits of any corporation. Section 26 (which is amended by the Act of 1942) is found in all the Revenue Acts, even after the Undistributed Surtax was repealed in 1938. It applies to all corporations and provides for the credits allowed corporations. It was to this section that the Revenue Act of 1942 added a subdivision "(f)", providing an additional credit to so-called "deficit corporations". There is absolutely no reason for saying that this subsection applies only to Undistributed Profits Surtaxes when justice and equity both point towards the intent of Congress to allow this credit in the case of all corporations, including Personal Holding Companies, and particularly since Congress put no limitation on the application of the new subsection.

That Section 26 applies as well to Personal Holding Companies as to other Companies is indicated from the further fact that in the section itself in defining and fixing the amount of the credit allowed, it is stated that the earnings and profits shall be computed without diminution by the amount of the tax imposed under certain stated sections, the last of which is Section 351, and Section 351 is the one which imposes the Personal Holding Company Surtax. Therefore, the argument of the respondent resolves itself into a contention that although Section 26(f), by its own terms applies to Personal Holding Corporations, it does not confer upon these same Personal Holding Corporations the benefit of the credits allowed therein. No such unfair and unreasonable intent should be imputed to Congress.

2. The Respondent argues that the same objections to the Constitutionality of the Personal Holding Company Surtax made by Petitioner have been considered and rejected by this Court in upholding the Undistributed Profits

Surtax on corporations, and cites the cases of *Helvering v. Northwest Steel Mills*, 311 U. S. 46, and *Crane-Johnson Co. v. Helvering*, 311 U. S. 54.

The questions presented in those cases were entirely different from those presented here. Neither of those taxpayers was a personal holding corporation, neither had a deficit at the beginning of the tax year together with a loss during the tax year and neither had an actual loss though a statutory "net income" during the tax year. Those are the facts with respect to Petitioner and upon which it relies.

If Northwest Steel Mills Co. or Crane-Johnson Co. had paid out to its stockholders the undistributed profits upon which it was assessed it would have violated the laws of the state of its incorporation but such distributions would have been taxable to its stockholders as dividends and it would have relieved itself of the undistributed profits tax. This follows because Section 115(a) of the Revenue Act of 1936 enlarged the scope of the definition of "dividend" to include any distribution "out of earnings and profits of the taxable year".

That situation is entirely different from the situation in which Petitioner found itself. Petitioner had statutory income for the year 1937 from dividends from stocks owned by it, but it had a loss of capital assets from the sale of some of those stocks at a loss. This loss wiped out its entire "earnings and profits of the taxable year" but it reduced its "net income" by only \$2,000. (Secs. 21, 22 and 23; Sec. 351 (b) of the Revenue Act of 1936.)

"Net income" is a statutory concept and may differ widely from an actual gain. "Earnings and profits", on the other hand, have the meaning which is ordinarily attached to those words. (*Commissioner v. Young Corporation*, 103 F. (2d) 137.)



Thus, while Petitioner had taxable net income for the year 1937, it had no "earnings or profits" for that year or for any previous year. Hence the payment by Petitioner to its stockholders of its statutory income for the tax year 1937 *would not* have relieved Petitioner from the tax upon its undistributed profits. This is made plain by Article 27 of Regulations 94 referred to at pages 17 and 18 of Petitioner's main Brief. This Article provides that "no dividends paid credit is allowed with respect to any distribution unless each of the shareholders \* \* \* receives a taxable dividend as a result of the distribution". Taxable dividends can be paid only from earnings and profits of the taxable year by a corporation having a deficit at the beginning of the taxable year.

Thus, according to the claims of Respondent, the luckless deficit corporation which had a loss at the beginning of the tax year and made an actual loss but a statutory gain during the tax year, not only has to pay an income tax upon a gain which is statutory only, but has to pay a 75% undistributed profits tax upon purely theoretical profits for failure to pay out to its stockholders taxable dividends when it cannot possibly make such payment.

If the claim of Respondent is correct each Personal Holding Corporation which had sold capital assets at a loss during 1937 in reliance upon the privilege which it had enjoyed for many years, would have to pay a withholding tax of 75% upon the amount of such losses unless it had a surplus at the beginning of the tax year equal to, or greater than, such losses, and unless it paid dividends to its stockholders from such surplus equal to such capital losses. If this be the intent of Congress it is clearly in violation of the Constitution and of Amendments 5th and 14th.

In *Foley Securities Corp. v. Commissioner*, 106 Fed. (2d) 731, cited by Respondent, the Court says, with respect

to Section 351 of the Revenue Act of 1934 which was in all respects similar to the Revenue Act of 1936 here under consideration, "There can be no doubt that the purpose of Congress in enacting Section 351 was to compel each personal holding company to distribute its current earnings instead of accumulating them so as to augment the income of its shareholders, thereby increasing the amount of their tax liability" (p. 734).

The Court further states that through an inadvertent omission by Congress, personal holding companies may be taxed in some cases for failure to distribute their statutory income even though the distribution thereof would not carry out the said intent of Congress because not constituting income in the hands of the shareholders (p. 734).

The Court then concludes its statement of the effect of the statute as follows:

"The vice of this statute as we see it is that Congress, in order to induce personal holding companies to distribute their current net earnings, and after placing all such companies in a class for the purpose of imposing a heavy surtax upon such of their current earnings as are not distributed as dividends to shareholders, used a restricted definition of the term 'dividends' in providing how the undistributed earnings should be computed, which had the effect of placing personal holding companies with a capital impairment in a far worse position than those without an impairment of capital, and this for no apparent reason. The result was that the former were penalized and required to pay a surtax upon all or a part of the income received and actually distributed by them, the amount of the surtax depending, of course, upon the extent of the impairment of their capital, so that those with the largest operating deficits were required to pay the largest surtaxes" (p. 735).

The Court stated that the inadvertence of Congress was subsequently corrected. That statement is correct as Congress, in the 1936 Revenue Act, made the term "dividends" include "earnings and profits of the taxable year". However, in 1937 Congress again restored the conditions which the Court criticised in the *Foley* case by denying to personal holding corporations the right to deduct losses from the sale of capital assets which right they had had theretofore, thereby imposing a tax on statutory profits for the year while allowing as a deduction only those payments to stockholders which could qualify as earnings and profits, which as above shown, were not the same thing at all and might be more or less.

It is true that the *Foley* case sustained the constitutionality of the 1934 law upon the ground that there was practically no control over Congress in tax matters and that it could make its taxing provisions as unfair and unreasonable as it chose. However, this decision was not appealed and the question of the validity of the 1934 statute has not been passed upon by this Court. Moreover the tax involved in 1934 was 30%, while in 1937 it was 75% and the admitted unreasonableness of Congress is accentuated to that extent.

The cases of *Noteman v. Welch*, 108 Fed. (2d) 206, and *Girard Inv. Co. v. Commissioner*, 122 Fed. (2d) 843, cited by Respondent (p. 6 of its brief), are not in point. The principal issue in those cases was whether or not the taxpayer was a Personal Holding Company. The question of the validity of the provisions, or rather, of the interpretation placed upon the Personal Holding Company Surtax provisions by the Circuit Court of Appeals in this case, was not passed upon by the Court in the *Noteman* case.

The case of *Simpson & Co. v. Helvering*, 128 Fed. (2d) 742, cited by the Respondent on page 6 of its brief, is not fully reported, but is in the form of a *per curiam* affirmance

on the authority of *Noteman v. Welch, supra*, as to one point, and *O'Sullivan Rubber Co. v. Commissioner*, 120 Fed. (2d) 845, as to another point, neither of which cases are in point.

**Conclusion.**

***The petition for a Writ of Certiorari should be granted and the decision below reversed.***

Dated: October 1st, 1943.

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